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IN THE

Supreme Court of the United States

OCTOBER TERM, 1947

No. 742

CONSOLIDATED GOLDACRES COMPANY, *Petitioner*

v.

COMMISSIONER OF INTERNAL REVENUE

On Petition for a Writ of Certiorari to the United States Circuit Court of Appeals for the Tenth Circuit

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BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Tax Court (R. 23-36) is reported in 8 T. C. 87. The opinion of the Circuit Court of Appeals (R. 41-47) is reported in 165 F. 2d 542.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on December 12, 1947. (R. 48.) The taxpayer's petition for rehearing (R. 49-58), filed December 31,

1947, was denied on January 14, 1948 (R. 59). The petition for a writ of certiorari was filed on April 13, 1948. The jurisdiction of this Court is invoked under Section 240(a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the courts below correctly held that the conditional sales contract for the purchase of mining machinery and plant by the taxpayer, pursuant to which title was retained by the vendor and payments were based on the amount of ore milled, did not constitute an "indebtedness * * * evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust" for the purpose of determining borrowed invested capital in computing excess profits taxes within the meaning of Section 719(a)(1) of the Internal Revenue Code.

STATUTE AND REGULATIONS INVOLVED

These are set out in the Appendix, *infra*, pp. 15-16.

STATEMENT

The facts as stipulated (R. 19-22) and as found by the Tax Court (R. 23-29) are as follows:

The taxpayer is a Nevada corporation with its principal office located in Denver, Colorado. The tax returns for the year ended November 30, 1942, were filed with the Collector of Internal Revenue for the District of Colorado on an accrual basis. (R. 23.)

On or about July 26, 1941, taxpayer entered into a contract, entitled "Contract of Conditional Sale" with

the Western-Knapp Engineering Company (referred to hereafter as Western-Knapp, or Seller), and under the same date taxpayer and Seller entered into an agreement, entitled "Supplemental Agreement on Conditional Sale", which was made a part of the above-mentioned contract by reference. (R. 23-24.)

The contract provided that Western-Knapp agreed to sell and taxpayer agreed to buy certain listed personal property; that the Seller would construct and/or install the property, pursuant to the terms of the supplemental agreement, on the premises of the taxpayer located in Lander County, Nevada; that in consideration of the performance by the Seller under the contract and supplemental agreement, the taxpayer would pay the Seller the sums at the time and in the manner specified in the supplemental agreement; that taxpayer, at its option, might pay sums in addition to the monthly installments provided in the supplemental agreements. It was further provided in the contract that all cost of collecting any amount or enforcing any of the Seller's rights should be paid by taxpayer; that title to and ownership in each and all of the personal property "are, and shall continue to be vested in Seller," until payment of the purchase price and the performance of all the covenants and conditions on the part of taxpayer and after payment in full of the purchase price and the performance of all the conditions by the taxpayer, the Seller agreed to execute and deliver to taxpayer a bill of sale to all the personal property. If the taxpayer's indebtedness, including

any of the installments of the purchase price, or interest due thereon, or any insurance premium, or any other indebtedness which might be payable by taxpayer to the Seller, should become due and remain unpaid or if there should be a default by the taxpayer in the performance of the terms and conditions of the agreement, then the full amount unpaid on all indebtedness would become due and payable by the taxpayer unless the taxpayer in 90 days corrects the default; and the Seller could take possession and dispose of the personal property and all payments theretofore made by the taxpayer were to be retained by the Seller in consideration of the use of the personal property while in the taxpayer's possession and not as a penalty; or the personal property could be sold without notice at public or private sale and the proceeds credited upon the amount unpaid. Taxpayer was to pay forthwith any balance unpaid. All equipment and other things which were placed on any of the personal property, described in the agreement, would at once become a component part thereof and would belong to the Seller. The Seller could inspect the personal property at any reasonable time. The Seller would be relieved from all damages, from whatever cause, arising from the personal property. The personal property, while in the taxpayer's possession, or under its control, was to be held at the risk of the buyer (except for insurance to by carried by the Seller, as set forth in the supplemental agreement as hereafter stated), and its loss, destruction or injury could not release the buyer from the

agreement. Time is of the essence of the agreement, both to the taxpayer and the Seller. (R. 24-25.)

Attached to the contract was a list of items which the Seller agreed to furnish. (R. 25.)

The supplemental agreement which referred to taxpayer as "owner" and Western-Knapp as "contractor" was executed the same day as the contract and made a part of the contract. It stated that the parties had entered into a contract of conditional sale covering the complete erection of a cyanide plant and a diesel electric plant on certain property owned by taxpayer in the State of Nevada. The contractor agreed to furnish all labor, materials and equipment necessary to construct and install the plant on taxpayer's property. Contractor was given five months from date of the agreement to complete, in every detail, the construction, erection and installation of the equipment. The supplemental agreement contained the following conditions pertaining to "payments" (R. 25-27):

> Payments: As consideration for the performance by the Contractor of the terms of this Agreement and of said Contract of Conditional Sale between the respective parties hereto, and of even date herewith, Owner agrees to pay to Contractor the total sum of Four Hundred Seventy-Five Thousand Dollars ($475,000.00) lawful money of the United States, which said sum is to be paid by Owner to Contractor in the following manner, viz: A sum in cash equal to One and 50/100 Dollars ($1.50) per ton for all ore and/or concentrates milled in said plant, until an aggregate of one

hundred fifty thousand (150,000) tons shall have been so milled in said plant, and thereafter, at the rate of One and 00/100 ($1.00) in cash for each such ton so milled in said plant, and, at all times, as much additional in cash as owner will then be able to pay to Contractor; said payments by Owner to Contractor shall be made monthly on or before the 15th day of each and every month, commencing on the 15th day of the month next following the date on the 15th day of the acceptance of said plant by Owner, and such monthly payments shall cover the amount so due to Contractor for the number of tons milled in said plant during the calendar month next preceding the said due date of said installment; said monthly payments to continue until the total purchase price above specified shall have been paid by Owner to Contractor, without interest, except that any installments of said purchase price which shall become delinquent hereunder shall bear interest at the rate of six per cent per annum from and after the due date thereof, if not so paid, and until paid.

Until all obligations of Owner to Contractor hereunder and under said Contract of Conditional Sale shall have been fully paid, the operations of said properties and plant of Owner shall be under the direct personal management of a managing operator to be employed by Owner but selected by Contractor, and who shall remain so in charge only so long as his said employment shall continue to be approved by Contractor, and to which such managing operator Owner shall pay compensation (or salary) amount to at least Five Hundred Dollars ($500.00) per month; and

> Likewise, until all such obligations of Owner to Contractor shall have been fully paid, Owner undertakes that all ore taken from the lode mining claims of Owner above-described, shall be delivered to and milled in said cyanide plant, and the above-mentioned payments shall be measured upon all tonnage milled in said plant, whether or not such ore and/or concentrates so milled in said plant shall be taken and/or mined from the premises of Owner and/of other persons; and until such full payment of said Owner's obligations to Contractor, Owner will, from and after the date possession of said plant is turned over to Owner, continuously and without interruption, mine said properties, and will operate said plant to the maximum possible operating capacity of said plant; and until such full payment of said Owner's obligations to Contractor, Contractor shall have access to the mill and/or office records, books and accounts of Owner is [sic] so far as they relate to and/or for the purposes of verifying the tonnage milled in said plant during any calendar month after the completion and acceptance of said plant and equipment, as hereinabove provided.

The contractor made certain warranties as to the work and material. Taxpayer agreed to continue to maintain clear and merchantable title to the lode mining claims and properties on which the plant was to be built. The contractor agreed to carry and pay for fire insurance upon the building and equipment in an amount equivalent to the full insurance value thereof and not less than one-third of the outstanding and unpaid balance owing to the contractor. The con-

tractor agreed to pay all personal property taxes assessed or levied by Lander County for the taxable year of 1942. In the event of default by taxpayer, the contractor had the right to take possession of the properties and claims of the taxpayer and the right, at its option, to exclusive management and control of the properties, as additional security for performance. If by operation the contractor obtained sums sufficient to discharge the contract, any surplus from such operations would belong to the owner, and the property should be redelivered to it. The contractor could sublet, but could not assign the whole or any part of its obligation without taxpayer's written consent. (R. 27.)

Both the contract and supplemental agreement were signed for the respective companies by their officials. (R. 28.)

The method of payment, as provided in the above contract and supplemental agreement, was changed as is indicated in a memorandum dated December 10, 1942, which provided in material part as follows (R. 28-29):

> 1. Under date of December 4, 1942, Mr. Ernest C. Kanzeler, Director General of Operations, War Production Board, notified Consolidated Goldacres Company that permission was granted for the treatment of not to exceed 3,000 tons of ore monthly for a period of six months, beginning December 8, 1942.
>
> * * * * * *
>
> 4. It was recognized that there would inevitably be some increase in the per ton operating costs be-

cause of the reduced scale of operations, and to enable both companies to participate in earnings, it was suggested that Mr. Bishop and accepted by Willow Creek Mines, Inc., representatives that the operating profit be divided 40% to Consolidated Goldacres Company and 60% to Western-Knapp Engineering Company. Western-Knapp Engineering Company's share of operating profits would be applied to payment on the master contracts between Consolidated Goldacres Company and Western-Knapp Engineering Company, dated July 26, 1941.

It was further agreed that the management fee to Willow Creek Mines, Inc. would be increased to 15c per ton in lieu of the 10c, as provided for in the contract dated July 26, 1941.

5. The arrangements, as above, to continue during such period of reduced operations until such time, if any, when the tonnage milled is in excess of 6,000 tons per month. Should the relief granted by the War Production Board be increased to such a point that the tonnage milled would reach a figure in excess of 6,000 tons per month, then the basis of settlement would revert to that of the original contracts unless adjusted by mutual agreement.

Up to July 31, 1945, the following payments were made by taxpayer to Western-Knapp pursuant to the contract of conditional sale, supplemental agreement on conditional sale and the memorandum of December 10, 1942 (R. 29):

During the year ended Nov. 30, 1942.....	$129,384.00
During the year ended Nov. 30, 1943.....	73,427.01
During the year ended Nov. 30, 1944.....	108,258.91
From Nov. 30, 1944 to July 31, 1945.....	53,057.30
Total.....	364,127.22

No additional sums were paid by the taxpayer over and above those required to be paid under said agreements and memorandum. (R. 29.)

The Tax Court held in a reviewed decision that the agreements did not constitute a "note", "mortgage", or any of the other types of instruments enumerated in Section 719 (a) (1) of the Internal Revenue Code and accordingly sustained the deficiency based on the conclusion that the amount involved was not borrowed invested capital. (R. 30-36.) The Circuit Court of Appeals affirmed. (R. 41-47.)

ARGUMENT

Both the Tax Court and the court below held, correctly we submit, that the amounts owed on the conditional sales contract in question do not constitute borrowed invested capital within the meaning of Section 719(a)(1) of the Internal Revenue Code (Appendix, *infra*). The pertinent language is that "borrowed capital" is the—

> * * * amount of the outstanding indebtedness * * * of the taxpayer which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage or deed of trust, * * *

The Tax Court held (R. 30-35) that neither in form nor in substance was the contract in question a note or a mortgage; that the instruments forming the agreement are bilateral and embody mutual obligations of the parties; that from a consideration of its terminology and form, and under general principles and Nevada law (the State in which the contract was to be performed), such a contract is distinguishable from a mortgage; and that Congress omitted conditional sales contracts from the terms of Section 719(a)(1). The Circuit Court of Appeals affirmed and held (R. 45), as had the Tax Court, (a) "that there was no unconditional promise to pay a certain sum of money at some future time" such as would constitute a "note", and (b) that the instruments involved are legally distinguishable from a "mortgage" as used by Congress in Section 719, as well as under Nevada law.

As the court below found (R. 45), the taxpayer's obligation to pay the purchase price was "equal to *and contingent upon* the amount of ore milled at the plant" (italics supplied), and until ore had actually been milled the obligation remained conditional. Thus, this condition removes the contract from the class of instruments specified by the statute (bond, note, bill of exchange, debenture, certificate of indebtedness) each of which embodies an unconditional indebtedness. The governing principles of law necessary to determine whether the contract in question constitutes a "note" or one of the other instruments mentioned, are undisputed, and the question whether these principles were correctly applied by both the Tax Court and the court

below is not one which would appear to merit further review by this Court.

The court below concluded (R. 44-47) that Congress deliberately chose to limit borrowed capital to indebtedness evidenced by the instruments specified in Section 719 and excluded therefrom conditional sales contracts. This conclusion is clearly supported by the legislative history of the statute, analyzed in the court's opinion. (R. 44.)

The decision below is in harmony with the decision in *Canister Co.* v. *Commissioner* (C.C.A. 3rd), decided January 20, 1948 (1948 P-H, par. 72,321), certiorari denied, April 19, 1948; *Frankel & Smith Beauty Departments, Inc.* v. *Commissioner* (C. C. A. 2d), decided March 22, 1948 (1948 P-H, par. 72,423), as well as with other decisions of the Tax Court such as *Journal Publishing Co.* v. *Commissioner,* 3 T.C. 518; *Flint Nortown Theatre Co.* v. *Commissioner,* 4 T.C. 536; *West Construction Co.* v. *Commissioner,* 7 T.C. 974; and *Gould & Eberhardt, Inc.* v. *Commissioner,* 9 T.C. 455.

The taxpayer asserts, however (Pet. 6-9), that the decision is in conflict with *Brewster Shirt Corp.* v. *Commissioner,* 159 F. 2d 227 (C.C.A. 2d), as well as with *Aetna Oil Co.* v. *Glenn,* 53 F. Supp. 961 (W.D. Ky.). But we submit that there plainly is no such conflict.

The basic question here (not at all present in the *Brewster* case) is whether Congress intended in using "well understood words" (*John Kelley Co.* v. *Commissioner,* 326 U. S. 521, 530) to ignore the distinction "recognized in legislation from early times" (*In re Lake's*

Laundry, 79 F. 2d 326, 328 (C.C.A. 2d), certiorari denied, 296 U. S. 622) between a conditional sales contract and a mortgage. The conclusion that it did not is justified by the reasoning of the court below and is quite consistent with the *Brewster* decision. In the latter case, the taxpayer had in effect mortgaged its accounts receivable to secure a loan and the court held that this arrangement was recognized under local law as a mortgage and fell within the language of Section 719. Here there is no comparable situation and hence no conflict. As noted by the court below (R. 47), the Circuit Court of Appeals for the Second Circuit went to great pains to distinguish the factual situation in the *Brewster* case from those cases on which the Tax Court had relied and which the court below deemed controlling in the present case. If the *Brewster* case presents a conflict it would only be because it stands for the rule that all written agreements regardless of form, which obligate a taxpayer to pay money, satisfy Section 719. That such a result was not intended is clear not only from the opinion itself but also the same court's most recent decision in *Frankel & Smith Beauty Departments, Inc.* v. *Commissioner, supra,* which held that a bilateral lease agreement was not a "note" under Section 719.

Reliance on *Aetna Oil Co.* v. *Glenn, supra,* as establishing a conflict is equally erroneous. That case—decided by a District Court—dealt with a different section of the law (Section 27(a)(4) of the Revenue Act of 1938, c. 289, 52 Stat. 447) which contained the phrase "indebtedness of any kind" rather than the more restrictive language in Section 719, involved

herein. Moreover, in contrast to the instant case, the court there expressly found the taxpayer's obligation to be unilateral and unconditional.

The taxpayer urges (Br. 50-51) that the rule of *Dobson* v. *Commissioner,* 320 U. S. 489, does not preclude a review of the decision here. Although we believe that *John Kelley Co.* v. *Commissioner, supra,* points to a contrary conclusion, the Tax Court's decision under any view is at least persuasive and should be accorded considerable weight. *Bazley* v. *Commissioner,* 331 U. S. 737, 742. In addition, the court below, while citing the *Dobson* and *Kelley* cases, reviewed the case on the merits and its agreement with the decision of the Tax Court is an expression of its own views as well. For the reasons already given, we submit that those views are sound and that there is no basis for any further review in this case.

CONCLUSION

The decision is correct; there is no conflict; the petition should be denied.

Respectfully submitted,

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May, 1948.

APPENDIX

Internal Revenue Code:

SEC. 719 [as added by Sec. 201, Second Revenue Act of 1940, c. 757, 54 Stat. 974].

BORROWED INVESTED CAPITAL.

(a) *Borrowed Capital.*—The borrowed capital for any day of any taxable year shall be determined as of the beginning of such day and shall be the sum of the following:

(1) The amount of the outstanding indebtedness (not including interest, * * *) of the taxpayer which is evidenced by a bond, note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, * * *

(b) *Borrowed Invested Capital.*—The borrowed invested capital for any day of any taxable year shall be determined as of the beginning of such day and shall be an amount equal to 50 per centum of the borrowed capital for such day.

(26 U.S.C., Supp. V, Sec. 719.)

Treasury Regulations 109, promulgated under the Internal Revenue Code, as amended by the Second Revenue Act of 1940:

SEC. 30.719-1 [as amended by T. D. 5267, 1943 Cum. Bull. 738]. *Borrowed invested capital.*—The borrowed invested capital for any day of the taxable year is 50 per cent of the borrowed capital for such day determined as of the beginning of such day. Borrowed capital is defined to mean:

(a) Outstanding indebtedness (other than interest and, in the case of taxable years beginning prior to January 1, 1941, for which the taxpayer

has not elected under the provisions of section 230 (d) of the Revenue Act of 1942 to make the provisions of section 760 applicable, other than indebtedness described in section 751 (b) relating to certain exchanges, but including indebtedness assumed or to which the taxpayer's property is subject) of the taxpayer which is evidenced by a bond, a promissory note, bill of exchange, debenture, certificate of indebtedness, mortgage, or deed of trust, plus

* * * * *

In order for any indebtedness to be included in borrowed capital it must be bona fide. It must be one incurred for business reasons and not merely to increase the excess profits credit. If indebtedness of the taxpayer is assumed by another person it ceases to be borrowed capital of the taxpayer. For such purpose an assumption of indebtedness includes the receipt of property subject to indebtedness.

Whether outstanding certificates designated by such names as "debenture preferred stock" or "guaranteed preferred stock" constitute borrowed capital depends upon whether the holder has a proprietary interest in the corporation or has the rights of a creditor, determined in the light of all the facts. The name borne by the certificate is of little importance. More important attributes to be considered are whether or not there is a maturity date, the source of payment of any "interest" or "dividend" specified in the certificate (whether only out of earnings or out of capital and earnings), rights to enforce payment, and other rights as compared with those of general creditors.

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